

FROM THE COMMISSIONER



I apologize as it has been some time since the Department has had a Newsletter going out to our industry informing you of the happenings at the Department of Financial Institutions. As you will see in this Newsletter, a number of things have happened, such as re-accreditation for the banking division and credit union division.

Currently, the Department is starting its budget projections for the next Legislative Session. We do not anticipate a lot of changes to the budget, but will ask the Legislature for additional dollars to help train our examiners in the banking, credit union, and consumer divisions. In addition, the Department may request an additional consumer position to keep abreast of the ever

increasing number of entities the Department licenses. The Department appreciates the support we have received from all the industries we regulate and hope we can continue to receive that support in the future.

We are in planning stages for an upcoming “Day with the Commissioner” for both the bank and credit union divisions, and encourage you to watch for these announcements and registrations so you can attend. There are a number of issues we are currently studying, such as the accounting for loan and lease losses, any changes that may happen to trust preferred securities, and any other issues that are submitted by the industry. If you have any comments or suggestions for the “Day with the Commissioner”, please feel free to contact anyone on the Department staff. The Department wishes the best of luck to all entities we regulate for a prosperous year in 2004.

STATE BANKING BOARD CHALLENGES FARM CREDIT SYSTEMS

At the November regularly scheduled State Banking Board meeting I had a copy of a newsletter from Farm Credit Services of Grand Forks. In that newsletter it states that you can improve your bottom line by taking advantage of the “Farm Cash Management” program. Farm Cash Management links your revolving line of credit from Farm Credit Services of Grand Forks to an Agri-bank money market investment account. The article goes on to state that instead of depositing business receipts into a bank and then writing a check to pay down your operating loan, your receipts are simply applied directly against your credit line and bills are then paid with a credit line draft. This keeps

your line of credit loan balance smaller, and that means a smaller interest expense. The article goes on to say at times when your credit line loan balance reaches zero, you can earn significant interest income on any additional funds through your Agri-bank money market investment account, where they earn interest comparable to a three or six month CD. Both the State Banking Board and I felt this account is a deposit account which is not insured by the Federal Deposit Insurance Corporation, and this activity goes beyond the authorized activities that can be done at Farm Credit Services of Grand Forks, or any other Farm Credit Services branch.

In addition, the Conference of State Bank Supervisors on January 30, 2004, wrote a comment letter to the Farm Credit Administration concerning its ability to provide farm management and agricultural trusts as related services to its members. The Farm Credit Administration responded to this Department in December 2003 indicating it feels it has the authority to offer to its members debentures which are used by its members to invest excess funds. The Department is currently reviewing whether or not it will take any further action on this matter, which could include issuing a Cease and Desist Order or initiating court action against Farm Credit Services for taking deposits. The Department would have to prove that the instrument currently offered is not a debenture, but is a deposit or transaction account.

LEASING ARRANGEMENTS

In the past year the Department's examiners have encountered a number of financial institutions which have been purchasing leases. What we have found is that it is fairly customary for the leasing company to collect the lease payments from the lessee and then forward payment to the purchasing financial institution. The weaknesses with this type of arrangement have become fairly obvious in that the financial institution is not aware of whether the lessee is actually making the payments or the true status of the lease as to whether the lease is current or past due. Additionally, the financial institution is retaining the risk if the lessee defaults, yet the payments are controlled by the leasing company. While this arrangement may be the industry standard the Department feels it would mitigate the risk to some extent if the payments were made, at the very least to a lock box either controlled by the bank or an independent third party. With a lock box arrangement the financial institution is more aware of the status of the lease and it would at the very least limit the possibility of a defalcation at the leasing company. The point of this article is to make you aware of the Department's position and the fact that we will be critical of management when we encounter these types of arrangements.

HOSELTON NAMED TO STATE EXAMINER REVIEW TEAM

Doug Hoselton from the Grand Forks field office has been named to a one year term on the State Examiner Review Team (SERT). Commissioner Tim Karsky stated "The Department is committed to this project". The addition of Hoselton to the task force enhances the image of DFI as well as the State of North Dakota, and demonstrates that DFI is a leader in improving the examination process with the use of technology. The State Examiner Review Team consists of six experienced state examiners, selected to serve by the Conference of State Bank Supervisors (CSBS) Technology Committee. The review team reports regularly to the CSBS Technology Committee. The Role of this team is to take an active part in the development cycle of any automated examination tool as directed specifically by the CSBS Technology Committee.


The sole focus of the State Examiner Review Team is to provide input as state bank examiners while working with staff from the FDIC and Federal Reserve to develop or enhance automated examination tools like General Examination System (GENESYS), Automated Loan Examination Review Tool (ALERT), Examination Documentation (ED), the Extranet, or any other applicable automated tool as directed by the CSBS Technology Committee.

The CSBS Technology Committee will continue to collaborate and coordinate with the federal agencies on broader policy issues related to automated examination tools and other technology issues that concern the state banking departments. Our thanks to Doug for serving as a team member.

ND Rules and Regulations...

... located on our web site

 [**DiscoverND.com/dfi**](http://DiscoverND.com/dfi)

 [**Rules and Regulations**](#)

EDUCATING BANKERS ON CSBS MEMBERSHIP

By Neil Milner, President and CEO

Supervisors and state bankers have a vital common interest in the health of the state banking system. Keeping the state banking system healthy is the mandate of the Conference of State Bank Supervisors, which is the prime reason why so many individual banks elect to be CSBS members.

Every state banker (or his or her predecessor) made a conscious decision to have a state charter, and for good reasons. The best supervision is local supervision, where regulators and regulated work together in a spirit of teamwork with common understanding of local economic conditions. The state banking system has produced almost every banking innovation in the last 100 years precisely because it does not attempt to make all institutions fit into a single regulatory mold, and local supervision is inherently more efficient and less paperwork-intensive than long-distance supervision.

That's why the Conference of State Bank Supervisors – the only national organization dedicated to protecting and enhancing the state banking system – includes all 54 banking departments and more than 1,700 individual bank members.

CSBS is integral to the success of the state banks and the state banking system. It works to enhance the value of state banks' charters and to protect the state system from federal encroachments. It promotes excellence among state banking departments and among the state bankers, as well as protecting our interests in Washington, D.C. Because of its work to streamline regulation and cut regulatory burdens, CSBS is the original cut-the-red-tape organization.

CSBS also offers tightly targeted educational services for examiners and bankers, exerts leadership in technology and provides a forum for all of us to work together when truly critical issues arise.

CSBS harnesses together the political power of thousands of state bankers and the prestige of the state banking departments, a combination that gives us horsepower (and staying power) on Capitol Hill. It also gives CSBS valuable leverage in its negotiations with federal banking agencies.

It's the nature of the federal animal to seek to grow, gain new jurisdictions and exert control. Those traits represent a constant threat to the state banking system, and CSBS works constantly to ward off federal encroachments on the powers and prerogatives of the state banking departments – encroachments that jeopardize the value of state bank charters. Without CSBS, the future would almost certainly hold a single federal regulator presiding over all banks.

The North Dakota Department of Financial Institutions will be sending further information on how to join CSBS if you so choose.

NORTH DAKOTA'S PRIVACY LAW

As I am sure you are aware, North Dakota's privacy law was amended in the 2003 Legislative session at the request of the banking and credit union trade organizations. Included among the amendments was an exemption which allowed the disclosure of customer information under section 502(e) of the federal Financial Services Modernization Act of 1999; the amendment went on to require this disclosure to comply with the rules adopted by the State Banking and State Credit Union Boards.

The proposed rules were published in early December 2003; a joint hearing with the State Banking and State Credit Union Boards was set for January 8, 2004. The purpose of the hearing was to entertain public comment received prior to the hearing, as well as provide a forum for public comment before the boards. The Boards heard testimony in favor of the proposed rules from Marilyn Foss, General Counsel for the North Dakota Bankers Association, and Greg Tschider, League Attorney for the North Dakota Credit Union League. ND law requires an additional 30 day comment period after the hearing for additional public comment; this comment period expired February 9, 2004. At this point the State Banking and State Credit Union Boards will consider the rules for final adoption at the March 11 and March 5 regular meetings, respectively. Once the Boards approve the respective rules they will be sent to the Attorney General's office to review the process to ensure the proper procedures were followed in the rulemaking process. Provided the Attorney General finds all procedures were properly followed, the Attorney General issues a letter to that effect and the rules will be sent to the Legislative Council for final

publication and an effective date will be issued. The Department then must appear before the Legislative Council's Administrative Rules Committee and once this committee approves the rules they are then final.

LOTTERY

With the coming of the Lottery to the State of North Dakota we thought it would be a perfect time to remind the industry of the FDIC Regulation regarding lotteries. The North Dakota Century Code does not specifically address banks participation in the lottery.

Below is an excerpt from the FDI Act, Section 20:

- SEC. 20 (a) A State nonmember insured bank may not--
- (1) deal in lottery tickets;
 - (2) deal in bets used as a means or substitute for participation in a lottery;
 - (3) announce, advertise, or publicize the existence of any lottery; or
 - (4) announce, advertise, or publicize the existence or identity of any participant or winner, as such, in a lottery.
- (b) A State nonmember insured bank may not permit--
- (1) the use of any part of any of its banking offices by any person for any purpose forbidden to the bank under subsection (a), or
 - (2) direct access by the public from any of its banking offices to any premises used by any person for any purpose forbidden to the bank under subsection (a).
- (c) As used in this section--
- (1) the term "deal in" includes making, taking, buying, selling, redeeming, or collecting.
 - (2) The term "lottery" includes any arrangement whereby three or more persons (the "participants") advance money or credit to another in exchange for the possibility or expectation that one or more but not all of the participants (the "winners") will receive by reason of their advances more than the amounts they have advanced, the identity of the winners being determined by any means which includes--
 - (A) a random selection;
 - (B) a game, race, or contest; or
 - (C) any record or tabulation of the result of one or

more events in which any participant has no interest except for its bearing upon the possibility that he may become a winner.

(3) The term "lottery ticket" includes any right, privilege, or possibility (and any ticket, receipt, record, or other evidence of any such right, privilege, or possibility) of becoming a winner in a lottery.

(d) Nothing contained in this section prohibits a State nonmember insured bank from accepting deposits or cashing or otherwise handling checks or other negotiable instruments, or performing other lawful banking services for a State operating a lottery, or for an officer or employee of that State who is charged with the administration of the lottery.

SIGNATURES ON CALL REPORTS

Over the last several years we have noticed that all state chartered banks have not complied with North Dakota Century Code Section 6-03-70. This Section deals with the submission of the quarterly Report of Condition and Income. In our March 2003 letter to all state-chartered banks we offered a gentle reminder that signatures must be affixed to the signature page of the Call Report. To quote the North Dakota Century Code, "Each report must be verified by the oath of the president or the cashier and attested as correct by at least two of the directors and must be transmitted to the commissioner within thirty days after receipt of the request for the same." The Department has made it a practice to accept copies of the Report of Condition and Income that is submitted to the federal regulator. Call report letters that we send out have a signature page included in the mailing. Compliance with the above law has been fairly good; however, every quarter there are always a few banks that forget to sign or send in the signature page. This information is offered as a reminder that we will accept either copies or original signatures and they must accompany the Call Report. Please take a moment of your time prior to the submission of the March 2004 Call Report to make sure that the appropriate documents are attached.

CREDIT UNION TRENDS AND INTEREST RATES

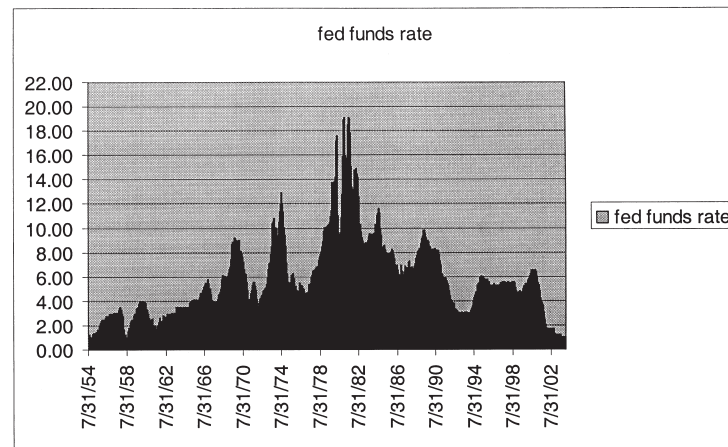
North Dakota state-chartered credit unions enjoyed another successful year in 2003. The state credit unions' net worth ratio increased from 9.90% to 10.40% during the year while total shares & deposits grew by 6.0%. Total assets grew from \$1.048 billion to \$1.118 billion during the year or by 6.7%. Net earnings grew from \$1.163 million to \$12.209 million.

Although net loan charge-offs increased from \$4,770,596 in 2002 to \$5,649,336 in 2003, the loan delinquency ratio fell from 1.92% on 12/31/02 to 1.58% on 12/31/03. Another indication of the improved quality in the loan portfolio is the decline in the Allowance for Loan & Lease Loss (ALLL) account. The ALLL account declined from \$21,777,563 on 12/31/02 to \$19,756,490 as of 12/31/03.

Overall financial performance continued to strengthen as the net interest spread widened due to a continued decline in interest rates and loan quality strengthened as evidenced by a decline in the Provision for Loan Loss (PLL) expense. The net interest spread is the difference between the yield on loans & investments less the cost of funds. In 2003, this net interest spread increased to \$39,676,492 from \$38,362,258 in 2002. The table below shows the improvement in the net interest spread, the decline in the PLL expense, and the improvement in net income from 2002 to 2003.

	12/31/02	12/31/03
Total Interest Income	\$61,443,108	\$57,323,495
Interest Expense	23,080,850	17,647,003
Net Interest Spread	38,362,258	39,676,492
PLL Expense	13,499,926	3,740,295
Non-Interest Income	7,586,277	11,351,515
Non-Interest Expense	31,285,566	35,077,926
Net Income	\$1,163,043	\$12,209,786

The year 2004 should prove to be a challenge in repeating the earnings performance of 2003 due to the continued low interest rate environment. As can be seen from the table above, credit unions' cost of funds re-priced faster than interest income with a decline of \$5.433 million in the cost of funds and a decline of \$4.119 million in interest income from 2002 to 2003. With continued historically low interest rates as measured by the fed funds rate (see chart below), we expect the net interest spread to decline in 2004 as loans re-price to lower rates faster than the cost of funds re-price, which are already at extremely low levels. Credit unions with excess liquidity have been hit harder than those credit unions with strong loan demand as



Source: Federal Reserve

yields on investments have fallen to historically low levels. However, these credit unions should recover nicely when interest rates begin to rise. It is always foolish to predict when this may happen, but a study of previous interest rate cycles shows we are probably closer to a bottom in interest rates and that an up-tick in rates could possibly start in the latter part of 2004. The table below compares this down cycle in interest rates with the previous seven down cycles since 1970 as measured by the 3 month Treasury Bill rate. As can be seen from this table, the current down cycle in rates is already one of the longest in terms of months of downward trend and one of the largest in terms of basis point decline in recent history.

It is interesting to note that the Fed has pushed interest rates so low that real interest rates (the interest rate less the inflation rate) have turned negative. With inflation at 1.92% and the fed funds rate at 1.00%, the real interest rate is a negative .92%. The chart below shows that this is a phenomenon that doesn't happen very frequently and has been followed by a brief and sharp up-tick in interest rates in the past.

Asset / liability management will continue to play a key role for credit unions in the foreseeable future as interest rates could prove to be volatile after this bottom in the interest rate cycle.

	Peak	Subsequent Bottom	# of Months	Basis Point Decline
Jan., 1970 – Feb., 1972	7.90%	3.20%	25	470
Aug., 1973 – Dec., 1976	8.60%	4.40%	40	420
May, 1979 – June, 1980	9.60%	7.00%	13	260
Dec., 1980 – Oct., 1982	15.70%	7.80%	22	790
Aug, 1984 – Oct., 1986	10.50%	5.20%	26	530
March, 1989 – Oct., 1992	8.90%	2.60%	43	630
Jan., 1995 – Oct., 1998	6.00%	4.32%	45	168
Oct., 2000 - ????	6.39%	??	40 so far	543 so far

	MONTANA	SOUTH DAKOTA	MINNESOTA	UNITED STATES	NORTH DAKOTA
ROAA	1.29%	1.23%	1.29%	1.12%	1.12%
NIM	4.76%	4.44%	4.50%	4.18%	4.23%
T1 Capital	9.75%	11.41%	9.47%	9.79%	9.74%

FINANCIAL PERFORMANCE OF NORTH DAKOTA BANKS AT YEAREND 2003

Overall, North Dakota banks performed well for 2003. The return on average assets (ROAA) for all banks was 1.12%. Tier One capital for North Dakota state-chartered banks at year end 2003 equalled 9.74%. How does North Dakota stack up with our neighbors? Please refer to the chart.

Asset quality information for state-chartered banks from reports of examination that were conducted over the last 12 months shows that the average classification ratio is 17.09%. Past due and nonaccrual loans were 1.94% and 2.45% of the loans are classified as a percent of all loans. There are 87 state-chartered banks as of this writing. As of December 31, 2003 these 87 banks are rated as follows: 41 are rated “1”, 39 are rated

“2”, and only 7 banks are rated “3”. These 87 state-chartered banks had total assets of \$7,378,314,000, and deposits of \$6,175,075,000. This represents asset growth of 9.64%, and deposit growth of 8.10%, compared to 12-31-02.

The numbers show what many of you already know – North Dakota state chartered banks are generally well-capitalized, profitable, and have financially sound loan portfolios. We believe banks that are well-run are the primary generators of economic development and growth, in their communities. Safe and sound banks are afforded additional opportunities to invest in their local communities.

State Banking Performance Summary

FDIC-Insured Institutions

	State Charter Commercial Banks North Dakota December 31, 2003			State Charter Commercial Banks North Dakota December 31, 2002			State Charter Commercial Banks North Dakota December 31, 2001		
	All	Assets less than \$100 million	Assets greater than \$100 million	All	Assets less than \$100 million	Assets greater than \$100 million	All	Assets less than \$100 million	Assets greater than \$100 million
<i>(dollar figures in millions)</i>	Institutions			Institutions			Institutions		
Number of institutions reporting	87	72	15	89	75	14	89	75	14
Total employees (full-time equivalent)	2,673	1,111	1,562	2,528	1,163	1,365	2,412	1,118	1,294
AGGREGATE CONDITION AND INCOME DATA									
Net income (year-to-date)	84	36	48	72	36	36	65	35	30
Total assets	7,378	3,153	4,226	6,730	3,226	3,503	6,306	3,095	3,211
Earning assets	6,740	2,868	3,872	6,144	2,931	3,212	5,778	2,822	2,956
Total loans & leases	5,043	1,928	3,115	4,516	1,974	2,542	4,187	1,878	2,308
Other real estate owned	4	2	2	4	3	1	4	3	1
Total deposits	6,175	2,697	3,478	5,713	2,755	2,957	5,401	2,666	2,735
Equity capital	716	337	378	663	351	312	597	332	265
PERFORMANCE RATIOS (YTD, %)									
Yield on earning assets	6.22	5.92	6.45	6.90	6.68	7.11	8.09	7.74	8.44
Cost of funding earning assets	1.86	1.75	1.94	2.46	2.41	2.51	3.79	3.60	3.98
Net interest margin	4.36	4.17	4.52	4.44	4.27	4.60	4.30	4.14	4.46
Noninterest income to avg. earning assets	0.78	0.60	0.91	0.71	0.56	0.86	0.71	0.54	0.87
Noninterest expense to avg. earning assets	3.21	3.08	3.30	3.18	3.08	3.27	3.12	2.95	3.29
Net charge-offs to loans & leases	0.31	0.16	0.40	0.30	0.24	0.34	0.38	0.23	0.50
Credit-loss provision to net charge-offs	114.01	132.42	109.20	178.12	142.16	197.81	129.86	116.85	134.76
Net operating income to average assets	1.18	1.17	1.19	1.11	1.15	1.07	1.06	1.15	0.98
Retained earnings to average equity	4.94	3.16	6.62	3.78	1.49	6.50	4.49	4.06	5.03
Pre tax return on assets	1.55	1.43	1.64	1.47	1.41	1.53	1.43	1.45	1.40
Return on assets	1.19	1.19	1.19	1.12	1.16	1.08	1.08	1.17	0.99
Return on equity	12.16	10.89	13.34	11.44	10.64	12.39	11.22	10.83	11.71
Percent of unprofitable institutions									
Percent of institutions with earning gains	58.62	54.17	80.00	65.17	64.00	71.43	53.93	53.33	57.14
CONDITION RATIOS (%)									
Net loans and leases to assets	67.25	60.08	72.60	65.96	60.09	71.36	65.32	59.62	70.81
Loss allowance to:									
Loans and leases	1.61	1.76	1.52	1.72	1.79	1.67	1.61	1.77	1.49
Noncurrent loans a	160.48	139.65	179.81	147.52	137.56	156.99	143.43	151.85	136.13
Noncurrent loans & leases to									
total loans & leas	1.00	1.26	0.84	1.17	1.30	1.06	1.12	1.16	1.09
Nonperforming assets to assets	0.74	0.83	0.66	0.85	0.90	0.80	0.81	0.79	0.82
Core deposits to total liabilities	80.31	85.10	76.80	81.84	84.68	79.29	82.83	85.62	80.22
Equity capital to total assets	9.70	10.70	8.96	9.85	10.89	8.90	9.47	10.72	8.26
Core capital (leverage) ratio	9.22	10.21	8.46	9.15	10.22	8.15	9.08	10.37	7.84
Total capital to risk-weighted assets	13.23	15.85	11.53	13.40	15.86	11.39	13.48	15.96	11.31
Gross 1-4 family mortgages to gross assets	6.85	4.63	8.50	7.14	4.88	9.22	7.17	4.99	9.27
Gross real estate assets to gross assets	35.13	29.94	39.00	32.94	29.71	35.92	32.12	28.94	35.18

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Dawn Ystaas, FI Examiner II
Mitzi Arnold, FI Examiner II
Vacant, FI Examiner III
Melette Anderson, FI Examiner I

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Dave Lessard, Supervising Examiner
Mike George, FI Examiner III
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Angie Mills, FI Examiner -II
Grand Forks Examination Crew
Doug Hoselton, Supervising Examiner
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STATE BANKING BOARD

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Bill Daniel	Public Member.....	Bismarck	223-8488
Launa Moldenhauer	Kirkwood Bank & Trust Co.....	Bismarck	258-6550
Roger Monson	The Citizens State Bank of Finley	Finley.....	524-1921
Gary Petersen	Lakeside State Bank.....	New Town.....	627-4717
Terry Zeltinger	United Community Bank of ND.....	Minot	839-3500

STATE CREDIT UNION BOARD

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